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July 18, 1996

David S. Guzy, Chief
Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

Dear Mr. Guzy,

RE: "Amendments to Gas Valuation Regulations for Federal Leases" published in Federal Register May 21, 1996, 61 F.R. 25421

The State and Tribal Royalty Audit Committee (STRAC) members of the Negotiated Rulemaking Committee (Committee) appreciate being given the opportunity to provide the following comments on the referenced Federal Register notice and on discussion taking place on June 12-14, 1996, with regard to the same topic. In addition to the comments provided below, STRAC hereby incorporates into this response our comments dated February 5, 1996, on the published Committee consensus at 60 F.R. 56007 (copy attached). STRAC specifically draws MMS's attention to page 2, third major paragraph, which addresses the fact that while published, posted prices for oil were once indicators of market value, the market has changed and posted prices are no longer representative. STRAC believes that there is danger in tying gas valuation to published prices because markets can change quickly.

STRAC members have participated in discussions regarding rules for valuing gas royalties and will continue such participation as the opportunity arises because we believe strongly in the need for rules that are equitable, simple, certain, revenue neutral, and accountable to the public as landowners. STRAC offers its comments in the spirit of assisting in achieving those objectives.

STRAC wishes to make a few general points of clarification that apply to all options. The importance of revenue neutrality cannot be overemphasized. STRAC believes that greater evidence exists today with regard to the value of gas being marketed in the FERC Order #636 environment than existed at the time of the Committee negotiations. Two known areas that already guarantee a loss in revenue are: 1) MMS's own pilot project involving gas taken in-kind offshore, and 2) proposed definitional changes to transportation and gathering, as they apply onshore. In addition, no recognition or discussion was held during the negotiation period concerning the movement of gas east out of the San Juan Basin in New Mexico and whether the index price referenced for that area recognized the true markets. Using Inside FERC for June 1996, the San Juan Basin price was $1.18 compared to $2.01 for the Permian Basin. That difference is significant as it relates to the actual transported markets versus the price recognized for that market. MMS must assure that if indices are used, that they truly support the markets to which the gas is transported.

Industry representatives have indicated that the Committee consensus consists of the "higher of" index values or gross proceeds as if this provides the federal government with assurance that no revenues will be lost, and in fact some may be gained. The Committee consensus, which included an index-based valuation method supported by a verified safety net, offered no such assurances. The safety net test consists of examining gross proceeds of payors with small market share who generally enter into dedicated contracts because they have little choice or those who have deliberately chosen to stay on gross proceeds because they will pay lower royalties than if they chose index.[1] When industry's own analysts make comparisons that assure us that index is on-average market value, those analyses are based on the assumption that **all** parties will pay on index. They do not factor into the equation the fact that companies with higher gross proceeds will go down to index while those with lower than index prices are allowed, under the original Committee consensus, to stay on gross proceeds. The fact that industry no longer supports a verified safety net compounds STRAC's concerns with regard to revenue neutrality, as discussed under "Other Points" below.

OPTIONS OUTLINED IN FEDERAL REGISTER NOTICE

STRAC will keep its comments brief with regard to these specific options because it appeared at the June 12-14, 1996, meeting that sufficient support was lacking for any of the options in this notice, as written, to go forward as a proposed or final rule.

Option #1: Original Committee consensus with minor modification

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[1] This is a major change from the current regulations which require producers *at a minimum* to pay on their own gross proceeds. Currently, the federal government participates in all parts of the business decision, including the choice of transportation options. Under all but a few of the options being considered, the federal government relinquishes being able to scrutinize the business decisions.

While this option would allow MMS to go forward quickly with a final rule, that advantage is outweighed by the disadvantages. STRAC feels the disadvantages are that this option: 1) continues to allow a cap on the safety net calculation; and 2) continues to allow a significant number of options from which companies can choose which leads to complexity in the rule and the ability of companies to thwart the objective of revenue neutrality.

With regard to whether there should be a cap on the safety net,[2] MMS must ask itself what it would have received in royalty revenues had the alternative valuation method not been in place. The historical position has been that gross proceeds is a floor for establishing royalty value. The alternative method already eliminates the gross proceeds floor--moving away from traditional gross proceeds. In theory, values calculated under the safety net are market values.[3] Therefore, in theory, MMS would have received the safety net value. STRAC believes that, even in theory, capping a company's obligation so that it pays less than the safety net value virtually assures that revenues will be lost.

Independent oil and gas companies criticized the Committee consensus as being too complex. STRAC concurs. STRAC believes that allowing so many options contributes to the complexity of this rule. With regard to Part 4 of Option #1, STRAC concurs with COPAS's recommendation (June Committee meeting) that exceptions be allowed on take-based reporting for 100 percent Federal agreements and stand-alone leases. With regard to Part 5 of Option #1, STRAC supports this concept with the following stipulation: If MMS fails to publish a safety net in two years, the difference between what the state received in royalty revenues and what the state should have received had MMS performed this responsibility timely will be made up through reducing administrative costs passed on to states under Net Receipts Sharing. STRAC does not support industry's position that index is the default if MMS fails to perform this computation timely.

With regard to Part 6 of Option #1, STRAC concurs that royalties would still be due on contract settlements. By agreeing to an alternative valuation method, STRAC did not agree to absolve royalty payors of royalty obligations that have already attached to production. If such were allowed, a company could simply elect to pay royalties on indices and escape all such obligations. With regard to Part 7 of Option #1, STRAC believes overtaken volumes should result in a volume credit as agreed upon by the

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[2]Which itself is only a median value.

[3]In actuality, STRAC believes that the safety net calculation will always be at a value lower than an average value. This is because any forward-thinking company that has a choice (and the alternative method is ripe with choices) regarding what it will pay royalties on will always choose the lower amount. Therefore, if that company's gross proceeds are higher than index, it will pay on index. If that company's gross proceeds are lower than index, it will pay on gross proceeds.

consensus report. Small operators have been granted an option; MMS has no control over which option eligible parties select and should not pay the price in terms of the administrative burden of calculating and refunding royalties. No values need to be attached to volumes unless they are undertaken and additional royalties are owed MMS.

Option #2: Self-implementing safety net

STRAC feels that this option more fairly places the burden for calculating the safety net on those who benefit. MMS does not benefit from calculating the safety net and will likely be in litigation every time it performs the computation, at least as the safety net was originally conceived. STRAC believes that a self-implementing safety net achieves revenue neutrality for both the federal government and individual companies (the latter because MMS proposes to issue a refund if gross proceeds are less than index-based values). Further, this option solves the problem where there are large variances in price, such as coal seam gas in the San Juan Basin or when the gas is marketed different from how the gas is recognized (see example above).

STRAC believes that a self-implementing safety net imposes less of a "burden" on industry than representatives expressed in the June Committee meeting. Under the original proposal, index payors still need to determine to which pool gas is going in order to correctly compute transportation. The self-implementing safety net computation would be zone-wide, once a year, rather than property-wide as it is now where each molecule must be traced and many, many adjusting entries must be made. STRAC believes this option is very different from the status quo; perhaps a clearer explanation regarding how this would work would be helpful for generating more support among those who would implement it.

While STRAC supports the self-implementing safety net concept, we have too many concerns regarding the original Committee consensus (discussed elsewhere in this response) to support this option as written.

STRAC feels compelled to address one other industry comment expressed during the June Committee meeting regarding this option. API indicated it did not support this option (and some other options both published in the referenced notice and discussed in the June Committee meeting) because it "reopens" the divisive issues of defining "gross proceeds" and sales to affiliates. STRAC believes that these issues go to the heart of royalty valuation; any rule that "works around" or simply ignores these issues cannot be in the public's best interests. MMS must take a stance to either accept this position that profits are being moved to an affiliate marketer and not treat it as gross proceeds or litigate it. Our question to MMS is: Why is an independent, who is not in a position to establish a marketing affiliate, treated differently than a major who has the reserves, operating power, and money to establish a marketing company?

Option #3: Simplify Committee consensus by eliminating some options and eliminating cap on safety net

While this option was designed to address the concerns STRAC and individual states raised in their responses to 60 F.R. 56007, STRAC cannot completely support it as written. The options eliminated in Parts 1 and 3 were not necessarily the ones with which we had concerns. STRAC strongly supports elimination of the cap on the safety net (Part 2). With regard to Part 5 addressing non-arm's-length, non-jurisdictional transportation, STRAC cannot concur with using third-party contracts for two reasons: 1) the percentage set by the Committee should be higher; and 2) MMS should consider using actual, reasonable costs. Either way, the total cost of transportation should not exceed 50% of the overall value of the gas. STRAC is divided on the treatment of gathering and compression (Part 6) with some members supporting the certainty this treatment offers while others preferring the current approach for both which incorporates "marketable condition." If a "bright line" test is used, it must be applied across the board to gas produced both onshore and offshore.

Option #4: Self-implementing safety net with simplifying some of Committee consensus

As discussed under option #2 above, STRAC supports a self-implementing safety net (Part 1 of this option). With regard to Part 2, STRAC cannot give full support to the required wellhead MMBtu because it is not certain that the uplift on NGLs has been captured. Given that not all gas has entrained liquids, there may not be a sufficient quantity within a given zone for the self-implementing safety net to work, particularly when the potential exists that MMS might have to issue refunds. With regard to Parts 4 and 5, see comments on Option #3, parts 5 and 6 respectively.

Option #5: Improved benchmarks

With the absence of a verified safety net (see "Other Points" below), STRAC has no choice but to support some version of this option. We recommend that MMS reconsider the plus or minus 20 percent; STRAC believes that percentage ought to be higher. In addition, under Part 2, STRAC could support a meaningful exception for smaller producers. Such exception should not be on a property basis, which would make it available to virtually all producers. Nor should such an exception be so broadly based as to make any kind of computer production/payment verification impossible. With regard to Part 4, see discussion under Option #3, Part 6.

OTHER POINTS OF DISCUSSION IN JUNE 12-14, 1996, MEETING

In the June Committee meeting, industry proposed to modify the original Committee consensus by having an unverified safety net and by revising the cap upward.[4] For clarification, STRAC would have MMS know that all references we made to a safety net in our February 5, 1996, response to the proposed rule meant a *verified* safety net. STRAC cannot support an index-based methodology without being certain that index prices are within the range of other parties' gross proceeds. Reported prices offer no certainty; they must be audited or verified. In Committee meetings and in formal responses, STRAC has clearly stated its position that a valid safety net is critical to index-based valuation. If there is to be no verified safety net, index-based valuation should not be allowed for royalty purposes.

MMS did not receive critical comments regarding the Committee's consensus on granting a small producer exception to payment on entitlements. Yet in the June meeting, industry recommended changing the Committee's agreement from a producer basis to a property basis. While STRAC supports a meaningful exception to payment on entitlements, we strongly object to exceptions on a property basis. Such a change is not in keeping with the spirit of the original agreement which was intended to give relief to small operators with cash flow problems. This proposal, if implemented, would make any kind of production/payment verification by computer impossible. This proposal expands the number of companies eligible for payment on entitlements to nearly 100 percent, making MMS's administrative costs of monitoring the true-up enormous. Because the States share in those administrative costs, STRAC cannot support this proposal.

MISCELLANEOUS COMMENTS

STRAC believes any relief for deepwater production should be given through royalty rate reductions. Therefore, STRAC recommends eliminating the deepwater exception as proposed by the Committee when calculating the safety net offshore. Gas produced in deepwater should true-up to the average value in the zone.

Some industry representatives expressed disappointment because it appeared that none of the published options allowed the de minimus transportation rate as originally conceived by the Committee. STRAC recommends that a de minimus rate be allowed on a company basis, subject to MMS approval, based on relevant criteria.

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[4]Again, in this proposal, industry would seek to avoid allowing MMS to apply its own definition of "gross proceeds." The gross proceeds index payors would "true-up" to would be gross proceeds as defined only by industry. Such definitions are unlikely to serve the best interests of the public.

It is not clear how the proposed options would affect the way POP (percentage of proceeds) gas is being handled. STRAC believes that under no circumstances should royalty producers who process their gas under POP contracts be allowed to pay on less than 100% of the value of the residue gas.

STRAC appreciates being given the opportunity to participate in this process and to provide comments. If you have any questions, please contact any of the STRAC Committee members.

Sincerely,

Wanda Fleming

Wanda Fleming
Committee Member

Valdean Severson

Valdean Severson
Committee Member

George Staigle

George Staigle
Committee Member

Brad L. Simpson

Brad L. Simpson
Committee Member